Counting on a crisis:
A CATALYST FOR INVESTMENT INNOVATION?

The confluence of challenges impacting pension funds, endowments and other institutional portfolios offers a much-needed catalyst for change - both in mindset and processes - believes Dr. Ashby Monk, Executive and Research Director at Stanford University's Long-Term Investing Program.

In the face of relentless macroeconomic, market and geopolitical headwinds, asset owners face a dilemma: how to evolve investment processes, operations and technology within organizational structures and cultures that, until now, have not felt a compelling need to innovate how they invest and manage portfolios.

Monk describes this as a "two-headed problem." While an asset owner's management generally has a genuine appetite for transformative change, the individuals tasked with deploying capital tend to be focused on performance benchmarks, so they look to avoid anything that disrupts strategy execution.

Even during today's fusion of high inflation, geopolitical tension and volatility, the prudent and conservative nature of institutional investment collides with various hurdles when trying to be innovative. These include a tendency to stay in-sync with what peers are doing. Further, boards of directors often prioritize efficiency, including minimizing running costs, which conflicts with making operational or process enhancements.

When referring to common perceptions among executives at pension funds and university endowments, Monk has found they often fall victim to a certain mentality that inhibits the possibility of innovation and change. "If you're working at a pension fund or university endowment, that fund or endowment will exist beyond you," he explains, in reference to a common attitude at such organizations. "That removes the most important incentive commercial organizations use to change: the fear of the organization's exit or demise."

Where mindsets can change, however, is when a crisis hits or, as is the case in today's environment, a series of shocks and scenarios that cannot be ignored – whether related to banking, climate, war or cost of living. "Innovation [within asset owners] seems to be mostly counter cyclical. We need a crisis to drive innovation," adds Monk.

BREAKING THE MOLD

The last 20 years offer evidence of crisis-led step changes in institutional investment. Monk points to the start of liability-driven investing in the wake of the sharp downturn in stock markets across the globe in 2002, and factor-based asset allocation following the global financial crisis in 2008.

Today's investment challenges have again triggered conversations about the need for change, despite there being a few tried-and-tested models of investment for asset owners. From the different approaches taken by different types of institutions – such as the Yale model of the 1980s to the newer Canadian model to the collaborative model at the California State Teachers Retirement System to the Norwegian model (highlighted in Monk's research paper The 'Investor Identity': The Ultimate Driver of Returns) – each institution applies its people, process, information and capital in a different way to produce returns.

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Yet the pressure to find new approaches, or new models of investment, is building, based on the acceptance of new tools and mindsets. "One of the big components of every [asset owners'] identity is its capacity to change," says Monk. "At a certain point, models will have to shift and change… And as we see technologies like generative artificial intelligence, I feel like there's an incredibly strong focus on the potential for a new 'technology model' for the first time."

Such a shift is based on what Monk sees as a new reality that obligates boards of directors to empower staff to do something new.

Notably, there is a relatively low bar for innovation within many asset owners when compared to other industries. Considering the capabilities of technology in creating driverless cars and putting helicopters on Mars, for example, pension funds are already set up to achieve what are perceived as innovation objectives such as organizing and managing their existing portfolio data more effectively.

It is often only once asset owners can answer fundamental questions to clarify portfolio positions – "What are we holding? What are our exposures? What are the risks?" – that they can identify a catalyst for change.

Monk refers to this as revealing their "portfolio GPS" – a concept akin to a blueprint of their portfolio makeup – which, once identified, can help kick-start the process toward achieving innovation.

INNOVATING TO CHANGE THE TIDE

Innovation inevitably involves adapting and evolving the roles of different individuals, as well as of operational and investment processes, and then powering these with new information to meet the demands of capital.

In line with this, Monk believes asset owners should typically look to use culture, governance or technology to power the transformative changes to asset allocation or its implementation.

This calls for a new culture of collaboration between teams and individuals across the organization, ranging from the chief operating officers (COOs) to chief executive officers (CEOs) to the people overseeing capital. It also requires specialist sub-committees to oversee areas such as governance in technology, data and innovation.

"To drive innovation in risk management and resilience calls for new technology, new data and measurable impact, plus traditional elements like volatility and variance. Asset owners need experts to run all this," says Monk.

Across the industry, this can spark collaborations between peers. In turn, asset owners can bypass the "prudent person rule" given they can then point to other funds and endowments taking similar approaches.

IMPLEMENTING INNOVATION AND REALIZING ROI

Once there is a blueprint for institutional innovation, putting the necessary data, trading, liquidity and other solutions in place requires asset owners to seek a new set of resources.

This is initially done via an outsourced front-office service, such as one that assumes the execution responsibilities for an investment manager's trading desk.

Such an approach delivers multiple benefits to complement the desired objectives set by the COO and other key stakeholders. For example, it can reduce ongoing infrastructure expenses and annual capital investment requirements, as well as regulatory overheads, complexities and costs. Further, it can increase an asset owner's focus on core investment competencies such as driving strategies from new market entry to international coverage and business continuity.

"Collaboration really empowers people to, first of all, understand the space and use resources more effectively, and then to avoid that career risk which often hinders people from taking that next step and innovate."

– Dr. Ashby Monk
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